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CITATIONS

684643—46

In the Supreme Court of the United States

October Term, 1945

No. 819

Canadian River Gas Company, petitioner

v.

Joseph T. Higgins, formerly United States Collector of Internal Revenue for the Third District of New York

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ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the District Court (R. 85–86) is not reported. The opinion of the Circuit Court of Appeals (R. 95–100) and the dissenting opinion of Judge Learned Hand (R. 100–101) are reported at 151 F. 2d 954.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on November 9, 1945. (R. 102.)

The petition for a writ of certiorari was filed on February 7, 1946. The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

1. Whether the lessee of a gas lease may reduce its taxable gross income by the amount of allocable portions of bonuses which had been paid in prior years to obtain the leases.

2. Whether the lessee, contrary to the explicit requirements of Article 23 (m)–1 (g) of Treasury Regulations 86 and 94, may include in its basis for percentage depletion that portion of the gross income from the sale of gas allocable to the bonuses paid.

STATUTES AND REGULATIONS INVOLVED

The applicable provisions of the statutes and regulations involved are set forth in the Appendix, *infra*.

STATEMENT

The facts in this case were stipulated by the parties (R. 25–84), and were found by the District Court as stipulated (R. 86–87).

The taxpayer is a corporation organized under the laws of Delaware and has its principal office at Colorado Springs, Colorado. For the taxable years in question, 1934–1936, the taxpayer filed its tax returns with, and paid its income and excess-profits taxes to the respondent, who was then the

Collector of Internal Revenue for the Third District of New York. (R. 26–32.)

During the taxable years involved, the taxpayer, as lessee, produced and sold natural gas under various oil and gas leases. (R. 32–33.) With respect to certain of the leases, there had previously been paid by the taxpayer, or its predecessor in interest, certain cash bonuses to the lessors who also retained the right to a specified percentage of production. (R. 33.) The Commissioner determined that the portion of the bonus payments allocable to the gas produced during the taxable years was in the following amounts: 1934—$20,511; 1935—$20,309.63; 1936—$15,122.80. (R. 30, 43.) The Commissioner further determined that there were deficiencies in income and excess-profits taxes which resulted from excessive deductions for depletion because the taxpayer included in its "gross income from the property" (which is the basis for percentage depletion under Section 114 (b) (3) of the Revenue Acts of 1934 and 1936) the above allocable amounts of the bonuses. (R. 26–30, 32.)

After payment of the deficiencies, the taxpayer filed claims for refunds for each of the taxable years. (R. 30–32.) After rejection of the claims, the taxpayer brought suit in the District Court to recover taxes paid in the following amounts, exclusive of interest: 1934—$3,845.76; 1935—$2,792.57; 1936—$2,268.42. The above amounts were

sought to be recovered on the theory that the taxpayer's gross taxable income should not include the allocable portions of the bonuses previously referred to. (R. 11, 16, 36.)

Alternatively, on the theory that it was entitled to a deduction for percentage depletion calculated without excluding any portion of the bonuses, the taxpayer sought recovery of the following amounts, exclusive of interest: 1934—$1,057.60; 1935—$767.96; 1936—$623.82. (R. 13, 18, 37.)

The District Court, after trial, dismissed the complaint. (R. 87.) The Circuit Court of Appeals affirmed the judgment of the District Court. (R. 102.)

ARGUMENT

1. The court below decided that the taxpayer, in computing its taxable income, was not entitled to any deduction on account of bonus payments previously made to its lessors in connection with the acquisition of certain gas leases. Holding that the bonus payments constituted a capital investment, the court rejected the contention that an aliquot portion of the payments was deductible as part of the cost of goods sold within the meaning of Article 22 (a)-5, Treasury Regulations 86 and 94 (Appendix, *infra*).

The decision below is correct. The proceeds received by the taxpayer from the production and sale of the gas ,which it was not obligated to pay to

anyone else, constituted its gross income under Section 22 (a) of the Revenue Acts of 1934 and 1936 (Appendix, *infra*). If, as we believe, the court below was correct in holding that the bonus payments were capital investments, no portion of those payments could be deducted as constituting the cost of goods sold, it being well settled that gross income includes the entire selling price of the minerals sold. *Stanton* v. *Baltic Mining Co.*, 240 U. S. 103; *Helvering* v. *Mountain Producers Corp.*, 303 U. S. 376. Since the taxpayer is unable to point to any other provision of the statute or regulations conferring a right to the claimed deduction (cf. *New Colonial Co.* v. *Helvering*, 292 U. S. 435, 440), the claims for refund were properly rejected. The taxpayer, however, asserts that the court erred in holding that the bonus payments were capital expenditures and contends that its ruling is inconsistent with the decisions of this Court that a bonus payment is taxable as ordinary income to the *lessor* (*Burnet* v. *Harmel*, 287 U. S. 103) and that the *lessor* is to be allowed depletion with respect to the bonus received (*Herring* v. *Commissioner*, 293 U. S. 322). (Pet. Br. 12–18.) As the court below pointed out, however, there is no inconsistency in holding that a payment may represent the cost of a capital acquisition by the payor and still be ordinary income to the payee. (R. 98–99.) Since the bonus payment is "consideration for the lease" (*Burnet* v.

Harmel, supra, page 112) which gives rise to valuable rights in the lessee to extract the minerals and retain the proceeds (*Douglas* v. *Commissioner,* 322 U. S. 275, 285–286), it constitutes a capital expenditure by the lessee (*United States* v. *Ludey,* 274 U. S. 295, 302–303).

There is no conflict with the decisions of this Court. Indeed, the issue is one which this Court has already refused to review by certiorari. *Sunray Oil Co.* v. *Commissioner,* 147 F. 2d 962 (C. C. A. 10th), certiorari denied, 325 U. S. 861.

2. The court below also held that, under Article 23 (m)-1 (g), Treasury Regulations 86 and 94 (Appendix, *infra*), the taxpayer was not entitled to percentage depletion on the amounts of the bonuses allocable to the product sold during the taxable years. This result plainly follows under the explicit language of the regulations. The taxpayer, however, contends that the regulations are invalid. (Pet. Br. 20–22.) This contention is clearly untenable. Since the lessor is entitled to percentage depletion on the bonus payments when received (*Herring* v. *Commissioner, supra*), and since the depletion deduction is a single allowance which must, under the statute, be apportioned between the lessor and lessee (*Helvering* v. *Twin Bell Syndicate,* 293 U. S. 312), it necessarily follows that the lessee may not have a deduction for depletion on any part of the bonus with respect to which the deduction was allow-

able to the lessor. The regulations, in providing that the lessee's "gross income from the property" may not include an allocable portion of any bonus payment, are thus designed to carry out the rule that two taxpayers may not secure an allowance with respect to the same item of depletion. Moreover, similar provisions have appeared in all Treasury Regulations beginning with Article 221 (g) Treasury Regulations 77, promulgated under the Revenue Act of 1932, Congress having meanwhile repeatedly reenacted the statutory provision to which it relates. In these circumstances, and in view of the provisions of Section 23 (m) that the allowance is to be made under rules and regulations prescribed by the Commissioner, the regulations are unassailable. *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, 309; *United States* v. *Dakota-Montana Oil Co.,* 288 U. S. 459, 466; *Quintana Petroleum Co.* v. *Commissioner,* 143 F. 2d 588 (C. C. A. 5th).

The decision below in this respect does not conflict with the holding of the court on the taxpayer's alternative argument. If Congress had intended that there should be an exclusion or deduction from "gross income" under Section 22 (a) for the allocable portion of the bonus which is required by Section 114 (b) (3) (Appendix, *infra*) to be excluded from the depletion basis, it would have so provided.

CONCLUSION

The decision below is correct and no conflict is presented. Accordingly, the petition for a writ of certiorari should be denied.

Respectfully submitted,

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March 1946.

APPENDIX

Revenue Act of 1934, c. 277, 48 Stat. 680:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME. In computing net income there shall be allowed as deductions:

(a) *Expenses.*—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * * and rentals or other payments required to be made as a condition to the continued use or possession, for purposes of the trade or business, of property to which the taxpayer has not taken or is not taking title or in which he has no equity.

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, * * * a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In any case in which it is ascertained as a result of operations or of development work that the recoverable units are greater or less than the prior estimate thereof, then such prior estimate (but not the basis for depletion) shall be revised and the allowance under this subsection for subsequent taxable years shall be based upon such revised estimate. In the case of leases the deductions shall be equitably apportioned between the lessor and lessee. * * * (For percentage depletion allowable under this subsection, see section 114 (b), (3) and (4).)

SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

* * * * *

(b) *Basis for Depletion.*—

(1) *General Rule.*—The basis upon which depletion is to be allowed in respect of any property shall be the adjusted basis provided in section 113 (b) for the purpose of determining the gain upon the sale or other disposition of such property, except as provided in paragraphs (2), (3), and (4) of this subsection.

* * * * *

(3) *Percentage Depletion for Oil and Gas Wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the

gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

Sections 22, 23 and 114 of the Revenue Act of 1936, c. 690, 49 Stat. 1648, are identical.

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

> ART. 22 (a)–5. *Gross income from business.*—In the case of a manufacturing, merchandising, or mining business "gross income" means the total sales, less the cost of goods sold, plus any income from investments and from incidental or outside operations or sources. In determining the gross income subtractions should not be made for depreciation, depletion, selling expenses, or losses, or for items not ordinarily used in computing the cost of goods sold. But see article 23 (m)–1.
>
> ART. 23 (m)–1 [as amended by T. D. 5413, 1944 Cum. Bull. 124]. *Depletion of mines, oil and gas wells, other natural deposits, and timber; depreciation of improvements.*—Section 23 (m) provides that there shall be allowed as a deduction in computing net income in the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of im-

provements. Section 114 prescribes the basis upon which depreciation and depletion are to be allowed.

Under these provisions of the Act the owner of an interest in mineral deposits, mineral properties, or timber, whether freehold or leasehold, is allowed annual depletion and depreciation deductions which, in the aggregate, will return to him the cost or other basis of such property as provided in section 113, plus, in either case, subsequent allowable capital additions (see articles 23 (m)–15 and 23 (m)–16) with the following exceptions and qualifications:

(1) In the case of coal mines, metal mines, sulphur mines or deposits, and oil and gas wells the aggregate annual allowable deductions may, because of percentage depletion, ultimately exceed the cost or other basis:

* * * * *

(g) The term "gross income from the property" as used in sections 114 (b) (3) and 114 (b) (4) and articles 23 (m)–1 to 23 (m)–28, inclusive, means the following:

In the case of oil and gas wells, "gross income from the property" as used in section 114 (b) (3) means the amount for which the taxpayer sells the oil and gas in the immediate vicinity of the well. * * *

* * * * *

In all cases there shall be excluded in determining the "gross income from the property" an amount equal to any rents or royalties which were paid or incurred by the taxpayer in respect of the property and are not otherwise excluded from the "gross income from the property." If royalties in

the form of bonus payments or advanced royalties (see article 23 (m)–10) have been paid in respect of the property in the taxable year or in prior years, the amount excluded from "gross income from the property" for the taxable year on account of such payments shall be an amount equal to that part of such payments which is allocable to the products sold during the taxable year.

*   *   *   *   *

ART. 23 (m)–10. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) If a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the basis for depletion as provided in section 114 (b) (1) or (2) which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the lessor's basis for depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

*   *   *   *   *

(d) In lieu of the treatment provided for in the above paragraphs the lessor of oil and gas wells may take as a depletion deduction in respect of any bonus or advanced royalty from the property for the taxable year 27½ per cent of the amount thereof; * * *

*   *   *   *   *

Substantially similar provisions are embodied in Treasury Regulations 94, promulgated under the Revenue Act of 1936.

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Supreme Court of the United States

OCTOBER TERM, 1945.

No. 819

CANADIAN RIVER GAS COMPANY,

Petitioner,

against

JOSEPH T. HIGGINS, FORMERLY UNITED STATES COLLECTOR OF INTERNAL REVENUE FOR THE THIRD DISTRICT OF NEW YORK,

Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SECOND CIRCUIT.

REPLY BRIEF FOR PETITIONER.

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